1/31/04

SELECTED 2004 DEVELOPMENTS IN CALIFORNIA CORPORATE LAW

CORPORATIONS COMMITTEE
STATE BAR OF CALIFORNIA, BUSINESS LAW SECTION

Suzanne L. Weakley, Editor

Note: *The following summary is limited to 2004 California legislation, selected state regulatory developments, and selected California court decisions. It does not include discussion of recent developments in federal securities law or regulation, or Delaware or other state corporate law, all of which may be highly relevant in California corporate law practice.*

State Legislation Adopted In 2004

SB 1306: Electronic Communications in Governance of Business Organizations
Chaptered August 23, 2004.

SB 1306, which became effective January 1, 2005 and was co-sponsored by the State Bar Corporations Committee, amends Cal. Corp. Code §§ 8, 195, 307, 314, 600, 601, 603, 1500, 1501, 5079, 5211, 5215, 5510, 5511, 5513, 6320, 6321, 6322, 7211, 7215, 7510, 7511, 7513, 8320, 8321, 8322, 9211, 9215, 9411, 9413, 9510, 12254, 12351, 12355, 12460, 12461, 12463, 12590, 12591, 12592, 16111, 16403, 1701, 17058, 17104, and 17106, and adds Cal. Corp. Code §§ 20 and 21, all relating to business organizations. The bill will permit the use of various types of electronic communications in governance activities of California corporations (profit, non-profit and special purpose), partnerships, and limited liability companies.

The following summary of selected provisions of SB 1306 focuses on its application in corporate governance. In general, the new law will permit corporations to use electronic communications (1) to send notices to and receive notices from directors and shareholders, (2) to solicit and receive written consents, and (3) to convene director and shareholder meetings.

Under SB 1306, the term "writing," when used in the context of communications between a corporation and its shareholders or directors, includes an "electronic transmission." An "electronic transmission" is defined as: (i) a communication delivered by facsimile or electronic mail when directed to the facsimile number or email address of the recipient on record with the corporation; (ii) posting on an electronic message board or network which the corporation has designated for such communications, or (iii) other means of electronic communication—in each case: (a) to a recipient who has provided unrevoked consent to the use of that means of communication, (b) that creates a record capable of retention, retrieval and review, and (c) that

may be converted into a clearly legible tangible form (e.g., printed in readable form). The third general category should allow future technology to be used in corporate governance without further legislative action.

One important qualifier in SB 1306 is that an electronic transmission by the corporation to an individual shareholder is not authorized unless the transmission satisfies the requirements that apply to a consumer consent to electronic records as provided in the federal Electronic Signatures in Global and National Commerce Act (E-SIGN), 15 USC §§7001–7031.

SB 1306 permits boards of directors to meet by webcast, video conferencing or other electronic means, provided that each director has consented to such meeting mechanism and a procedure to establish authenticity of those attending is in place.

The new law also allows corporations to hold shareholder meetings by means of electronic communication, provided that each shareholder participating electronically has consented to such meeting mechanism and a procedure to establish authenticity of the shareholders attending electronically is in place. If all shareholders have not consented to holding a meeting via electronic transmission, the corporation may still conduct the shareholder meeting in part electronically, but also must provide a physical location for participation in the meeting. The selected electronic media must afford the shareholders a reasonable opportunity to participate, and create a record of voting and other actions taken at the meeting.

SB 1306 also permits electronic transmission of (i) notices to and from shareholders and directors under specified conditions, (ii) written shareholder and director consents, and (iii) the corporation's annual report to shareholders.

The new law provides that corporate documents such as bylaws, minutes of meetings, and adopted resolutions that are retained in electronic form and certified by the secretary of the corporation shall have equal weight as hard copies as prima facie evidence of the adoption of such bylaws, minutes or resolutions. In addition, SB 1306 permits corporations to retain copies of minutes, books and records in written form or in any other form capable of being converted into clearly legible paper form that would be admissible in evidence.

SB 1306 also contains applicable conforming provisions relating to LLCs and partnerships.

For the text of SB 1306 as signed by the Governor, see:
http://www.leginfo.ca.gov/pub/03-04/bill/sen/sb_1301-1350/sb_1306_bill_20040823_chaptered.html

AB 1000: Corporations: Disclosure Statement (Clean-up of AB 55)
Chaptered September 27, 2004.

AB 55, enacted in 2002, imposed new disclosure requirements beginning in 2003 for California corporations and foreign corporations qualified to do business in California, particularly public-traded companies. AB 1000 is a clean-up measure enacted to amend Cal. Corp. Code §§ 1501 and 2117, to add Cal. Corp. Code §§ 1502.1 and 2117.1, and to amend Cal. Govt. Code § 12186

relating to corporations. It includes minor corrections, some definitional and other conforming changes, but does not address all of the requirements and definitions that are inconsistent with federal securities law. In his signing message, the Governor noted that AB 1000 was a half-step and encouraged additional legislation that would conform California's disclosure requirements to those under the federal securities laws.

For the text of AB 55 as signed by the Governor, see:
http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab_0951-1000/ab_1000_bill_20040927_chaptered.html

AB 1859: LLC Dissolutions
Chaptered September 9, 2004.

AB 1859 provides that, if a domestic limited liability company has not conducted any business, a majority of the managers or members, or the person or a majority of the persons signing the articles of organization, may execute and acknowledge a certificate of cancellation of the articles of organization meeting specified criteria. The new law requires that a certificate of cancellation be filed with the Secretary of State within 12 months of the filing of the articles of organization. The law also provides that, upon the filing of that certificate of cancellation, a limited liability company is cancelled and its powers, rights, and privileges cease. The limited liability company will be exempted from the requirement to obtain a tax clearance certificate and requires the Secretary of State to notify the Franchise Tax Board of that cancellation.

For the text of AB 1859 as signed by the Governor, see:
http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab_1851-1900/ab_1859_bill_20040909_chaptered.html

AB 2167: Rescission Rights Against Unauthorized Broker-Dealers
Chaptered September 18, 2004.

AB 2167 authorizes a person who purchases a security from, or sells a security to, an unlicensed broker-dealer to bring an action for rescission of the sale or purchase, or for damages if neither party currently own the security, and authorizes the court to award reasonable attorneys' fees and costs to the plaintiff. The Corporate Securities Act of 1968 makes it unlawful for a person to engage in certain fraudulent practices and prohibited acts. Existing state law authorizes a civil action against a person who willfully violates these provisions, which must be brought within 4 years of the violation or within one year after the plaintiff's discovery of the violation, whichever comes first. The new law extends the statute of limitations for a civil action for violation to 5 years after the violation, or 2 years after discovery of the violation, whichever comes first.

For the text of AB 2167 as signed by the Governor, see:
http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab_2151-2200/ab_2167_bill_20040918_chaptered.html

AB 3070: Electronic Securities Filings
Chaptered September 10, 2004.

AB 3070 amends Cal. Corp. Code § 25102.1 to permit the electronic filing of Form D (Notice of Sale of Securities Pursuant to Regulation D, Section 4(6), And/Or Uniform Limited Offering Exemption) as filed with the Securities Exchange Commission for certain nonpublic securities offerings. The new law also requires all investment adviser and investment adviser representative applications and fees to be filed electronically with the NASD's Investment Adviser Registration Depository.

For the text of AB 3070 as signed by the Governor, see http://www.leginfo.ca.gov/pub/03-04/bill/asm/ab_3051-3100/ab_3070_bill_20040910_chaptered.html

Proposition 64: Limits on Private Enforcement of Unfair Competition Laws.
Voted into law November 2, 2004

This ballot initiative amended Cal. Bus. & Prof. Code §§17203, 17204, 17206, 17535 and 17536. Proposition 64 implemented major reforms of California's unfair competition law. It includes new standing requirements for lawsuits by private citizens, such that a plaintiff must now have suffered injury in fact and have lost money or property as a result of unfair competition as a condition of maintaining a suit. It also requires that any person who brings suit as a representative of others must meet the procedural requirements for class actions, including commonality of issues, typicality of the plaintiff, adequacy of representation, and superiority of method. See Cal. Civ. Proc. Code § 382. No representative suits on behalf of the general public may be brought by anyone other than the California attorney general or local government prosecutors. The initiative also made changes to provisions for civil penalties.

For the text of Proposition 64, see http://www.voterguide.ss.ca.gov/propositions/prop64text.pdf

State Regulatory Developments

California Secretary of State

The California Secretary of State has instituted its new online UCC service, UCC Connect, for online submission of UCC filings, inquiries, and orders for copies and debtor search certificates on records filed with the Secretary of State's office. See http://www.ss.ca.gov/business/ucc/ucc.htm

In response to the enactment of A.B.1000, effective September 27, 2004, the California Secretary of State has added features to its website to assist publicly traded corporations in complying with the new law. See http://www.ss.ca.gov/business/corp/corp_soinfo.htm. Website users may download the new Form SI-PT, Corporate Disclosure Statement – Publicly Traded Corporations, which must be filed annually, within 150 days after the end of the corporation's fiscal year, in accordance with Cal. Corp. Code § 1502.1.

California Department of Corporations

Effective April 13, 2004, the California Corporations Commissioner adopted changes to Title 10 California Code of Regulations § 260.102.14(e) pursuant to the Corporate Securities Law of 1968, to allow for the electronic filing of the notice of reliance on the exemption in Cal. Corp. Code § 25102(f) for the offer and sale of securities. The new online filing service includes credit card payment features. See http://www.corp.ca.gov/loen/loen.htm. The Commissioner has also proposed amendments to Cal. Code Reg. § 260.102.14(a)(2) that would mandate electronic filing of § 25102(f) notices, to improve government efficiency and public service and reduce costs. The final text of the proposed rule is at: http://www.corp.ca.gov/pol/rm/190415dayft.pdf

The California Corporations Commissioner has amended Title 10 California Code of Regulations § 260.102.14, to clarify the time period for filing a notice of exemption under Cal. Corp. Code § 25102(f). These amendments became effective on October 27, 2004.

On May 28, 2004, the Commissioner issued Release No. 115-C (Revised) to establish the maximum statutory filing fees pursuant to Cal. Corp. Code § 25608.3. The maximum filing fees associated with Cal. Corp. Code §§ 25102(f) and 25102.1(d) are effective October 1, 2004.

On January 1, 2005, legislation becomes effective to require all investment adviser and investment adviser representative applications and related materials and fees to be filed electronically with the Investment Adviser Registration Depository ("IARD") operated by the National Association of Securities Dealers ("NASD"). The Department of Corporations has issued a notice to California-registered investment advisors concerning participation in the IARD. See http://www.corp.ca.gov/notices/25231b.pdf

California Supreme Court

On March 10, 2004, the California Supreme Court approved new rules to permit the practice of law in California by lawyers not licensed to practice in California. In approving the Report of the California Supreme Court Multijurisdictional Practice Implementation Committee, the Supreme Court's new rules would enable out-of-state lawyers to practice law in California: (i) as registered legal services attorneys for up to three years, (ii) as registered in-house counsel for a single, qualifying institution, (iii) temporarily as part of litigation, and (iv) temporarily as part of a nonlitigation matter. The full text of the report can be found on the Supreme Court's website at http://www.courtinfo.ca.gov/reference/documents/mjpfinalrept.pdf .

Selected 2004 California Case Decisions

Fraud, Negligent Misrepresentation.

Vega v. Jones, Day, Reavis & Pogue, 121 Cal. App. 4th 282, 17 Cal. Rptr. 3d 26 (Cal. App. 2004).

The shareholder of a company acquired in a merger transaction sued the law firm that had represented the acquiring company (Transmedia) for fraud and negligent misrepresentation. He alleged that the firm had concealed certain "toxic" terms of a third-party financing transaction and thus fraudulently induced him to exchange his stock in the acquired company worth $3.45 million for restricted stock of Transmedia. He further alleged as follows: (i) the third-party investors in the financing transaction received convertible preferred stock that seriously diluted the shares of all other Transmedia shareholders; (ii) the law firm prepared a two-page disclosure schedule describing the terms of the "toxic" financing, but did not send the disclosure schedule to the plaintiff; (iii) the law firm knew that the "toxic" terms would have killed the acquisition transaction, which in turn was a condition to obtaining the financing; (iv) the law firm told the plaintiff and his attorneys that the financing was "standard" and "nothing unusual," and furnished the plaintiff's attorneys with a "sanitized" version of the disclosure schedule, which did not mention the "toxic" provisions; and (v) plaintiff did not have actual knowledge of the "toxic" terms until eight months after the closing.

The superior court granted the law firm's demurrer on several grounds, including the following: (i) plaintiff did not allege an affirmative misstatement by the defendant law firm; (ii) the law firm owed no duty of disclosure to plaintiff, (iii) plaintiff could not justifiably have relied on the law firm's statements. The court of appeal reversed and remanded the case for further proceedings. The court noted that a lawyer's duty of care extends only to his or her own client, but this limitation on a lawyer's liability for professional negligence does not apply to liability for fraud. In communicating with a nonclient, a lawyer may not knowingly make a false statement of material fact, and may be liable for fraudulent statements made during business negotiations. The court ruled that the law firm's statements that the financing was "standard" and "nothing unusual" were merely casual expressions of belief and not actionable, but that provision of the "sanitized" disclosure statement raised the issue of active concealment. The court held that because the law firm specifically undertook to disclose the financing transaction, it was not at liberty to conceal a material term. "[T]he telling of a half-truth calculated to deceive is fraud." 121 Cal. App. 4th at 292.

Attorney-Client Privilege.

Venture Law Group v Superior Ct., 118 Cal. App. 4th 96, 12 Cal. Rptr. 3d 656 (Cal. App. 2004).

Minority shareholders of predecessor corporation (Soft Plus) sued the merged corporation and the former majority shareholders of Soft Plus, alleging (among other things) that they had been denied inspection rights and dissenters' appraisal rights. Defendants asserted reliance on the advice of legal counsel. Plaintiffs sought to depose the former attorney for Soft Plus, who

refused to answer questions concerning the legal advice given on the grounds of attorney-client privilege. The trial court granted the plaintiffs' motion to compel, and the attorney appealed, contending that the successor corporation now held the privilege and had not waived it. The court of appeal agreed, and directed the trial court to vacate its order. Under Cal. Evid. Code §953(d), after a merger, the attorney-client privilege of the merged corporation belongs to the successor corporation, and the attorney had a duty to exercise the privilege unless and until the holder of the privilege instructs otherwise.

McKesson HBOC, Inc. v. Superior Ct., 115 Cal. App. 4th 1229, 9 Cal. Rptr. 3d 812 (2004).

Plaintiffs moved to compel McKesson to produce an audit committee report and interview memoranda prepared by counsel for internal use where McKesson had already shared those documents with government agencies. The superior court granted the motion to compel, holding that in producing documents for certain parties, McKesson waived attorney-client and work-product privileges for those documents with regards to all parties. The court of appeal rejected the selective waiver doctrine as against California policies concerning attorney-client and work-product protections. The California Supreme Court denied rehearing on June 9, 2004.

Contracts: Predispute Jury Trial Waivers.

Grafton Partners v. Superior Ct., 115 Cal. App. 4th 700, 9 Cal Rptr. 3d 511 (Cal. App. 2004). Review granted, ordered depublished by *Grafton Partners, LP v. Superior Ct*., 12 Cal. Rptr. 3d 287, 88 P.3d 24, 2004 Cal. LEXIS 3488 (Cal. 2004).

The parties' agreement contained a waiver of the right to a jury trial in the event of a dispute. A dispute arose; the clients brought a breach of contract action against the firm, and demanded a jury trial. The superior court struck the demand based on the waiver provision. On review, the court of appeals directed the superior court to vacate its ruling, holding that the right to a civil jury trial may only be waived as the legislature has prescribed. The court rejected the firm's argument that a written, pre-dispute jury waiver filed following the commencement of a civil action was valid, basing their reasoning on Cal. Code Civ. Proc. § 631 and Cal. Const. art. I, § 16. The court held that § 631 precludes the interpretation that the California Arbitration Act was intended to authorize an alternate means to effectuate civil jury waivers in the judicial forum. Because predispute jury waivers were not authorized, the parties' agreement to waive the right to a jury trial was unenforceable.

Practice Note: *Grafton* conflicts directly with a previous case, *Trizec Properties, Inc. v. Superior Ct.,* 229 Cal.App.3d 1616, 280 Cal. Rptr. 885 (Cal. App. 1991), which upheld the validity of a jury waiver in a commercial contract. Because *Trizec* and *Grafton* were decided in different districts, there is currently no definitive answer to whether predispute jury trial waivers are enforceable under California law. Until the California Supreme Court rules on this point, the uncertainty surrounding the enforceability of jury trial waivers makes it advisable to refrain from giving legal opinions on such enforceability.

Contracts: Consideration
Shareholders' Inspection Rights.

Jara v. Suprema Meats, Inc., 121 Cal. App. 4th 1238, 18 Cal. Rptr. 3d 187 (Cal. App. 2004).

Minority shareholder sued corporation and two majority shareholders alleging (i) breach of an oral contract that the majority shareholders would not increase their salaries without unanimous consent of all shareholders, (ii) breach of fiduciary duty by majority shareholders by paying themselves excessive compensation and denying plaintiff a fair share of corporate profits, and (iii) majority shareholders' violation of Cal. Corp. Code § 1601 by refusing plaintiff's requests for copies of corporate financial records. The court of appeal ruled that a majority shareholder's oral promise not to increase salaries was an unsolicited, gratuitous promise, not a bargained-for exchange, and therefore did not constitute valid consideration for an enforceable contract. The court also ruled that the trial court had erred in dismissing plaintiff's claim for breach of fiduciary duty, and that plaintiff's claim need not be brought in a derivative action but could proceed as an individual action. Finally, the court held that Cal. Corp. Code § 1601 did not require the corporation to mail monthly financial statements to the plaintiff, but only to make its financial records available for inspection and copying at its corporate offices. Section 1601 did not create an affirmative duty on the part of the corporation to respond to plaintiff's written demands for monthly statements, because plaintiff's demands fell outside the scope of the corporation's statutory disclosure obligations.

Contracts: Covenant of Good Faith and Fair Dealing.

Pasadena Live, LLC v. City of Pasadena, 114 Cal. App. 4th 1089, 8 Cal. Rptr. 3d 233 (Cal. App. 2004).

Pasadena Live claimed that it had an agreement with the city under which Pasadena Live would pay for renovations of an amphitheater in a city park, and the city would negotiate in good faith for a long-term lease of the amphitheater by Pasadena Live and evaluate Pasadena Live's applications for events on the same basis as other producers. Pasadena Live paid the city $114,550 for the renovations; the city then sent Pasadena Live a letter, barring it from submitting applications for events. After the renovations were complete, Pasadena Live sued the city for breach of the covenant of good faith and fair dealing, claiming that the city had not negotiated in good faith, had not dealt with it fairly, had refused it access to the amphitheater, and had refused to enter into a long-term lease. The trial court granted the city's demurrer on grounds that the complaint did not allege a breach of contract. The court of appeal reversed, holding that the trial court erred because a breach of the implied covenant of good faith and fair dealing is an actionable breach of contract, and gives rise to claim for contract damages. The city's barring of Pasadena Live's submissions for events constituted a breach of the city's contractual obligation to consider applications submitted by Pasadena Live on the same basis as those from other producers.

Contracts: Third-Party Beneficiaries.

Prouty v. Gores Technology Group, 121 Cal. App. 4th 1225, 18 Cal. Rptr. 3d 178 (Cal. App. 2004).

Defendant entered into a stock purchase agreement under which it agreed to purchases all of the stock of a subsidiary of Hewlett-Packard. The contract included a provision that defendant would offer continued employment and certain severance benefits to the employees of the subsidiary, but also included a provision that no third parties were intended to benefit from the contract. Defendant terminated plaintiffs' employment a week after the closing. Plaintiffs claimed that defendant did not comply with the contract provisions relating to severance pay and termination. The trial court ruled that the plaintiffs could not recover under the contract, but the court of appeal reversed. Relying on Cal. Civ. Code § 1559, the appeals court held that the test for third-party beneficiary status is whether an intent to benefit a third party appears from the terms of the contract. If the contract terms require the promisor to confer a benefit on a third person, then the contracting parties are presumed to contemplate a benefit to the third party. The court found that defendant and the seller expressly intended to grant the plaintiff-employees certain benefits under the contract, notwithstanding the conflicting provision that no third parties were intended to benefit from it. Drawing from established principles of contract interpretation, the court held that the particular provision regarding continuous employment and severance superceded the more general provision negating third party beneficiaries. The employees were therefore intended third party beneficiaries and could recover under the contract.

Involuntary Dissolution.

Kline Hawkes California SBIC, L.P. v. Superior Ct., 117 Cal. App. 4th 183, 11 Cal. Rptr. 3d 581 (Cal. App. 2004).

Preferred stockholders filed petition for involuntary dissolution and liquidation of the corporation. Under Cal. Corp. Code § 1800(a)(2)(iii), an action for involuntary dissolution may be filed by a shareholder or shareholders holding at least 33-1/3% of the equity of the corporation. The question was whether the preferred shareholders had standing to bring the dissolution action under this subsection. The court of appeal reviewed the legislative history of § 1800(a)(2), noting that it was intended to apply to corporations with multi-class stock structures, and ruled that both common and preferred shares could serve as a measure of the equity of the corporation. The corporation's equity is determined under Cal. Corp. Code § 2004, as the value of the corporation's property or business over its liabilities. That portion of the equity of a corporation allocable to preferred stock outstanding is the liquidation preference of the preferred stock plus any accrued and unpaid dividends. The court found it was likely that the plaintiffs' liquidation preference constituted 33-1/3% of the equity of the corporation, and granted plaintiffs leave to amend their dissolution petition.